ARE STOCK DIVIDENDS INCOME?

Among the difficult problems raised by our income tax is that of the nature of stock dividends. Under the act of 1913 they were held to be income by an interpretation placed on the law by the Department of Internal Revenue. In the act of 1916 they were made specifically taxable as income. Some time after the enactment of this law the Supreme Court decided that the administrative interpretation of the act of 1913 was erroneous,[1] and that the word income as used in that act did not include stock dividends. The question now arises whether the act of 1916 is constitutional in declaring stock dividends to be income. It is being hotly disputed in a case[2] now pending and which, although already argued once, is to be reargued in the autumn of 1919. We have accordingly deemed it wise to consider the problem purely from the economic point of view, especially as the subject has hitherto received comparatively little attention.[3]

In order to prepare the way for the discussion we must travel over more or less familiar ground; but it will, we hope, soon appear that the subject deserves a considerably closer analysis than it has yet received. We shall therefore start out with the concepts of income and of capital.

1. *What is Income?*

The most natural definition of income is all wealth that comes in. This, however, obviously is entirely too vague. The things that come in are fundamentally utilities and services. We desire things, at bottom, because of their utility. They can impart this utility only in the shape of pleasurable sensations or satisfactions. These alone constitute true income. If the satisfaction comes from a human effort we speak of a service; if it comes from material things or relations we speak of a use or utility. The satisfactions are afforded by the services of human beings and the utilities of material things or relations. Income is the inflow of satisfactions from services and utilities. Income is therefore fundamentally pleasure or benefit income.

[1] *Towne* v. *Eisner,* 255 U. S., 418.

[2] *Eisner* v. *Macomber.*

[3] The only discussion of the topic is the short colloquy between Professor F. R. Fairchild and Mr. H. H. Bond in the *Bulletin of the National Tax Association,* vol. III, pp. 161-3 and 237-243. Professor Davenport has also contributed a brief note in the same *Bulletin,* vol. IV, p. 53. Professor Irving Fisher does not deal with the problem in *The Nature of Capital and Income.*

When these services or utility-affording commodities are restricted in quantity, and cost some effort to procure, they acquire a value. Since we must economize in their enjoyment and use, we speak of them as economic goods and services. Economic value or value in economic life is therefore to be distinguished from other forms of value like aesthetic or moral value. In civilized society this value has come to be estimated in terms of money. Income is accordingly now used to denote the inflow or revenue in money. Speaking more broadly, however, it may be said that in a society based on money transactions income denotes any inflow of satisfactions which can be parted with for money. It may not be money income, but it must be capable of being transmuted into money income.

The second characteristic of income is that it denotes a flow or succession of such satisfactions, expressed in money or money's worth, during a period of time. If there is only a single utility or a unique service, we speak of an accession, rather than of a succession, of satisfactions. But whether there be one or many, we think of their coming in during a period of time. The quality of periodicity is essential. Thus, income must be either annual, or monthly, or daily income, or income for some other period of time.

Thus far the ordinary analysis has gone. There still remain, however, other criteria of income.

Since the real wealth of an individual or a community consists of this inflow of satisfactions that we call income, it is clear that the satisfaction must be realized before we can predicate of it the quality of income. The satisfaction may come from the repair of a broken stove, from the occupation of a house, from a foal born to a broodmare. The plumber affords a service, the house yields an immaterial benefit, the mare produces a commodity. The employer or owner can sell the services of the plumber, rent the house, or dispose of the foal. In each case he secures a money income. He is able to do this because the other party receives a corresponding income in the shape of satisfaction. The stove owner has a good fire, the tenant enjoys shelter, the purchaser of the foal acquires a saddle horse. The first party's money income is correlative to the second party's pleasure income which, if not money, is money's worth.

If now the plumber falls ill, if the house is unrented or untenated, if the foal is stillborn, there is no income to the employer or

owner, because nothing is realized. The plumber continues, perhaps, to be paid by the month, the house still commands a market price, the broodmare is still worth a definite amount, because in each case a steady income is anticipated. It is only when the failure of the income is repeated that the wages of the plumber and the value of the house or the mare will fall. On the other hand, the repair to the stove may be so badly made that the stove is still useless; the house may turn out to be so leaky as to be uninhabitable; the foal may be so defective as to be unusable. The gain which it was thought would be enjoyed has not been realized. There is in truth no income. And under a proper legal system it is possible to recover what has been paid so that the employer, landlord, or horse-trader likewise loses his income. The net result is that an unrealized or imaginary income is not an income at all. Just as a true satisfaction is realized satisfaction, so true income is realized income. In order to constitute income, the anticipated or putative gain must be not only realizable, but realized. If it is not realized, there is no income. Realization is a necessary attribute of income.

The next characteristic of income is that it is something distinct and separate from the person or thing that affords the income. Where the income consists of concrete objects, this is quite obvious. Each foal is separate from the mare and cannot possibly be confused with its mother. The succession of separate foals constitute the income and perhaps the only income from the mare. The mare is, so to speak, a bundle of inchoate or unborn foals. When the foal is actually born and separated from its mother, it constitutes the income from the mother; just as the fruit separated from the tree is the income from the tree. The same thing is true, however, in the other cases. The income of the house is really separate from the house itself. The house is to all intents and purposes a bundle of inchoate utilities: it will afford these utilities from year to year. The owner may during any given period dispose of the utility while retaining the title to the house. The rental that he receives by separating the actual utility from the bundle of inchoate utilities that we call the house constitutes his income from the house. Separation is of the essence of the enjoyment. The same finally is true of the plumber. His skill is indeed a part of him; but in order to secure the income that we call wages he must transmute his skill into something outside of, and separate from, himself. At a particular period he may ren-

der a service in repairing the stove; the service is then something separate from the man. If he disposes of the service, he enjoys an income. But he cannot secure the income without performing—that is, divesting himself of—this service. Separation, again, is of the nature of the transaction.

Thus in every case, whether we are dealing with human services, immaterial utilities or concrete objects, there can be no income unless there is a separation from the individual or the thing that affords the service or the utility. Separation, like realization, is a necessary attribute of income.

2. *What is Capital?*

As against the income, which, as we have seen, is the satisfaction afforded by services or utilities, is the capital. When we buy anything, we buy the right of securing such a satisfaction or stream of satisfactions from the commodity which embodies the utilities. Every commodity is a store of such future or inchoate satisfactions. Since human beings are no longer bought and sold, and since wealth exists for man rather than man for wealth, we can no longer buy the source of human services, although we buy the services themselves. We can only buy things or the source of non-human utilities. The process of valuation through which we assign a capital value to this complex of future anticipated income values, and through which the flow of satisfactions is transmuted into a fund, is called capitalization. At a given time the object or relation which affords the utilities or the income is called the capital. The capital possesses a value which reflects our estimate of the succession of anticipated utilities or income. Nothing would have any capital value if it possessed no income value.

Common usage distinguishes between a particular piece of capital (technically known as a capital good) like a house or a machine, and the fund of capital which represents the translation into money of the value of the particular pieces of capital. These may wear out and disappear; but, if they are replaced by others, the fund remains intact. As has been so well said, the fund of capital is like a mill pond: the drops of water flow in at one end and out at the other. But the pond itself, although continually changing, remains at a level, with the same volume of contents. The fund of capital is the mill pond: the particular pieces of capital are the drops that are continually flowing in and out of the

pond. Capital, in the sense of a fund, is used to designate the *caput* or principal sum of money from which a revenue is expected.

Income is spoken of as a result of the capital. In reality, capital or capital value is a result of the income or income value. Capital, again, is spoken of as the source of income. In reality, the income or income value is the source of capital or capital value. Physically, the fruit is a product of the tree; economically, the tree has a value only because the fruit has a value. To all intents and purposes it is correct to say that capital produces an income; strictly speaking, however, the capital is produced by the income, or at least the capital value depends on the income value.

The real distinction between income and capital as the embodiment or the measurement of wealth, therefore, is that income represents a flow or stream of utilities or money, and capital represents a fund or stock of utilities or money. The flow or stream is periodic; it represents a succession of utilities or money during a period of time. The fund or stock is the accumulation of such utilities or income at an instant of time. Income is expressed in terms of a flow; capital in terms of a stock. The capital value of anything at any instant of time is primarily the result of adding together the present worth of each and all of the anticipated successive income values. The income is primary; the capital is secondary.

3. *The Relation between Capital and Income*

We are now in a position to study some of the relations of capital and income.

In some cases there seems to be no distinction between the two. This is of course not ordinarily true. The value of anything, is, as we have seen, ultimately derived from the satisfactions or uses which it affords. Some things, like a city lot, are permanent and afford a use in perpetuity. The capital or selling value of the lot, however, is not a summation of all future income or rental values from the lot. By the very constitution of human nature we lay more stress on present than on future enjoyments; our present estimate of future uses becomes fainter as the use recedes into the future, until the present value of a very distant use vanishes entirely. The selling or capital value of a lot is accordingly only twenty or twenty-five times the rental or income value. Land is worth, as we say, about twenty-five years' purchase. Other commodities are less permanent, and are gradually worn out by use.

The distinction between the capital and the income value is then considerably less, as in the case of an automobile. The man who rents out an automobile must secure in the first year as income perhaps one third or one half of its capital value.

Finally, there are commodities which afford only a single use; the use of an ordinary article of food consists in its consumption. In this case the distinction between capital and income disappears. Capital, as we have seen, is a capitalization of incomes, a summation of our present estimates of the value of all future anticipated uses. But if there is only a single use, there can be no summation of successive uses. There can be no capitalization of a single use. Since, however, we speak of capital as a stock of wealth existing at an instant of time, while income is the flow of wealth during a period of time, the apple which affords only a single income is popularly regarded as capital. Yet its price, although ordinarily called a selling price, might equally well be called a rental price. In charging for its use, we charge for the apple itself. The capital and the income coalesce.

In this case, therefore, we must qualify the statement made above that separation is of the essence of income. If there is no difference between capital and income, we cannot separate the two. In all other cases however, that is, in the great mass of wealth (except that destined for immediate and total consumption), the distinction holds good. Income is something separate from capital; and if capital be regarded as the stock which yields the income, the enjoyment or money's worth in the shape of gain must, in order to constitute income, be separated from the capital.

It follows from this that if the income is separated from the capital and if we desire a continuance of the income, the capital must remain intact. In any particular piece of capital, this does not, of course, happen of itself. If the commodity is permanent, like a city plot, the capital indeed remains unimpaired. But in the great mass of cases the commodity gradually disappears through use. Some things are consumed in a short time, others last a longer time; but in almost all cases there is a wear and tear which, if allowed to go unchecked, finally renders the commodity useless so that it will cease yielding an income. There will be no net revenue because the cost of repairs will ultimately equal the gross returns. In actual life we sometimes guard against the results of such depreciation by instituting a sinking fund. Instead of spending all the earnings, we set aside an annual sum which will

exactly counterbalance the depreciation, so that at the end of the period the accumulated fund will sink or offset the outlay incurred to replace the commodity.

In order to estimate the real net income from a piece of capital we must therefore deduct from the earnings the amount of the annual depreciation charge, which will vary with the durability or permanence of the commodity in question. Otherwise, in separating the income from the capital we should be depleting the capital. Income in the true sense of net income is that which is separated from the capital, while leaving the capital intact. As it has elsewhere been defined:

"Income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for purposes of consumption, so that in consuming it, his capital remains unimpaired."[4]

4. *Income and Accretion to Capital*

We are now prepared to consider a more difficult problem. If my income increases, there is undeniably an increase in my wealth, or a net gain. This increase of wealth or gain, however, may also show itself in a change of my capital or my assets. In that case we speak of an accretion to capital or a capital increment. How, now, are we to determine whether a particular gain is income or accretion to capital. This question needs a more careful analysis than it has hitherto received.

In the case of a concrete commodity the capital or selling value may change for three reasons.

In the first place the income may not be consumed, but saved and added to the capital. There is indeed a difference here between money and money's worth, between a fund of capital and piece of capital. If I have a fund of capital, as $100, and decide to save the income of $5, I shall have at the end of the year $105, and with each ensuing year correspondingly more capital. This accretion to capital is clearly nothing but accumulated or reconverted income. The income has been realized and separated from the principal. While indeed it is now again merged with the principal, it is easy to keep the two sums separate and distinct. No one can question the fact that the gain, even though added to the capital, is pure income.

In the case of money's worth or utilities the matter is a little

[4] Seligman, *The Income Tax,* p. 19.

more complex. The income of many things is not embodied in an object, but consists of utilities that are incapable of being accumulated and that must be enjoyed or consumed at once. A house is of use only for habitation. We cannot make the house more valuable by postponing or deferring its use. We cannot reconvert the use or income into capital. If the use is not enjoyed, it is lost. There can therefore be no capital increment through a postponement or accumulation of income.

Where the income consists, however, of material objects capable of preservation, the matter is simple. The farmer's crop is his income. If he elects to add his crop of cotton to his previously existing stock (which he may be holding for a rise), this increment of capital is undeniably income. The new crop is something separate from the old stock. In the same way, the owner of a herd of cattle may decide not to sell his yearlings. Although they may be merged with the herd, however, they are none the less separate; for it makes no difference whether he keeps them in a distinct enclosure or lets them pasture with their mothers. The increment in the value of the herd is income, because it is both realized and separated.

Finally, there are cases where the income, if not originally separated, cannot be kept separated. The best example of this is a growing forest. The income of a forest is the annual yield of timber. The trees of a certain size may be cut yearly, leaving the forest intact. With proper forestry there will be a steady and regular cut of timber, what is lumbered in any year being made good by the growth of the remaining and oncoming trees. If, however, the trees are not cut, the forest becomes more valuable— up to a certain point at least. What would have been income has been converted into capital increment. But this capital increment is not income, because it has not been separated and because it is not capable of separation if uncut. When the trees are ultimately cut, the gain undoubtedly becomes income. Up to that time, however, the increase in the value of the forest is only inchoate income. What is done with the particular trees therefore determines whether they are income or capital. To the owner of the forest there is an increment of wealth in each case; but from the economic point of view there is a distinction between the increase in the form of income and the increase in the form of capital. If the income is immediately enjoyed or dissipated, the increase of wealth disappears in the enjoyment; if the enjoyment of the income is

postponed or deferred, the increase of wealth is not dissipated. In the one case we have spending, in the other saving. Capital can be increased only by postponement of enjoyment. Modern life with its mastery of science over nature enables the community not only to spend more for the conveniences and luxuries of life, but also to save more and thus to accumulate capital.

We see then that if the income has been actually realized and separated and then again added to, or reconverted into, the capital, it remains none the less income although called capital increment. But if the income is simply unconsumed or postponed, without being actually realized and separated, the resulting capital increment is not income. What we are dealing with in such a case is inchoate, not real, income. Realizability is not realization; separability is not separation. The gain in the form of accretion to capital is income only when it is the result of adding actually received (*i.e.*, realized and separated) income to the capital. Otherwise the gain is inchoate income, to become real income only when it is actually realized.

The second case of a change in the value of capital referred to above on page 523 is that due to a change in the income from the capital. The demand for the particular satisfaction or commodity may decline: ostrich feathers may go out of fashion; Sicilian oranges may no longer command a market in New York in competition with Florida fruit. This diminution in income will be at once reflected or amortized in a reduction of the value of the capital. If ostriches are raised primarily for feathers, their value will fall; if the Sicilian lands are of little use for other crops they will decrease in value, as indeed has actually happened. On the contrary, an increase in the income will be capitalized into an enhancement of the capital. If dry farming or irrigation causes two blades to grow in place of one, not only is the income from the land greater, but the land itself will rise in value. Capital is capitalized income. In such cases, therefore, there is no difficulty. We are in presence of two separate phenomena—an increase of income and an increase of capital. The one is the result of the other, but there is no danger of their confusion. The owner of the commodity enjoys two increments or gains—a capital gain and an income gain. The gain in the value of the capital is not income, because it is not separated and realized.

When, instead of a particular commodity or capital good, we deal with a fund of capital, the same is true. If the dividends of

a stock increase, the market price of the stock will rise. Both capital and income are enhanced in value. But the augmented value of the stock is not income as long as the stock is not sold, *i.e.*, as long as there is neither realization nor separation.

In the third place a change in capital may supervene without any change in the income. A plot of land may rent at the same figure as before, but a speculative move in the market may enhance its selling price. A stock may become valuable for purposes of control, even though the dividend rate remains unchanged; and its market value will quickly rise. In all these cases we have a capital increment with no change in income.

In reality, however, the discrepancy in many such cases is less than it seems. The present income, it is true, remains the same, but there is an expectation of greater income in the future. The boom in real estate is based on the idea that the rental value of the land will rise. The control of the stock is sought for in the hope ultimately of securing a gain through the augmented returns. Capital is a capitalization not simply of present or actual income but of the present worth of all future anticipated incomes. There can be no permanent change in the value of the capital unless there is at least an anticipated change in future income.

It remains true, nevertheless, that there may be temporary and ephemeral fluctuations of market price in complete disregard of future or anticipated incomes, and where the particular commodity or security is desired for other purposes than the income immediately to be derived therefrom. It is equally true that no small part of business profits is due to such fluctuations of price. Here again, however, there is no danger of confusing capital increment with income. For, as in the preceding case, the gain derived from such fluctuations becomes income only when the attributes of separation and realization are present. If the house appreciates in value because some one desires it for a particular purpose, the increase is income if I sell the house. But if I do not dispose of the house, the gain is only an inchoate gain, not a realized gain. Since there is no separation and no realization, the capital increment does not constitute income.

Thus all cases of appreciation of capital may be resolved into three types:

1) The capital increment is the accumulation of past income.

2) The capital increment is the result of augmented present and future income.

3) The capital increment is independent of change in the income.

In the first case the capital increment is undoubtedly income. In the two other cases it becomes income only when actually realized and separated from the principal. Until then it remains inchoate income, not actual income; a paper gain, not an actual gain. Thus in all three cases realization and separation constitute the true criteria of income.

5. *What is Taxable Income?*

When income taxes were first introduced, economic science was only in its infancy and the above analysis of the relations between capital and income had not yet been worked out. We therefore find a considerable confusion and diversity in the earlier income tax laws of various states, some survivals of which have persisted even to this day.

In the first place, income was commonly limited to money income. Difficulties, however, soon arose in the case of farmers consuming their own produce and individuals residing in their own houses. The truer conception of income as benefit income was only slowly adopted. If I own my house and receive no money income, I am not taxed under the present law in the United States: if I sell the house and devote the income of the proceeds to renting another house of precisely the same character, I am compelled to pay the income tax. Yet the economic situation is essentially the same, and the similarity was recognized in the Civil War income taxes.[5] In the case of farmers' produce our present law occupies a middle position: crops consumed by the farmer or his family are held not to be income, but the expenses involved in raising the crop cannot be deducted. These inconsistencies, which are no doubt retained in the law partly for administrative reasons, would disappear if it were recognized that income is not only money, but money's worth.

Secondly, we find in the original conception of income the idea of regularity. Only those incomings or net money receipts which were regularly received in the course of economic activity were considered income. Thus for a long time occasional earnings from gambling were not considered income, as was the case also with chance finds or gains. If, however, these finds, as *e.g.*, of precious metals, were the result of continued and regular effort they were held to be taxable income.

[5] *Cf.* Seligman, *The Income Tax,* pp. 443-445.

This idea of regularity gradually disappeared as the true nature of income came to be recognized. But the survivals of the old idea are still occasionally to be found. Inheritances, for instance, are today scarcely anywhere deemed to be taxable income. From the point of view of the individual, however, they constitute income, even though it be accidental and not regular income. As a consequence they are now almost everywhere separately taxed, although not under an income tax law. For the real economic justification of the inheritance tax on the share going to the recipient (as distinguished from the tax on the estate of the decedent) is that it constitutes accidental income and thus augments his ability to pay. Again, in many income tax laws, like our own, gifts are held to be capital or corpus and not income, evidently on the theory that they do not constitute regularly accruing gains. If the gift, however, were made periodically, an interesting question would arise.

In general, then, it may be said that the element of regularity as an essential constituent of the concept of income has well nigh disappeared. If I receive a thousand dollars for particular services this year and nothing in previous or subsequent years, it is none the less held to be income, even though it be irregular. The old conception of regularity, however, as we have seen, still survives in part.

In the third place, the original conception of income was limited to the usufruct of a commodity, without allowing for a gain derived from the disposal of the commodity itself. Later the conception was broadened, but only in part. In England, for instance, the decision was influenced by the idea of regularity, just discussed. That is, gains derived from the sale of property are even today considered income only if made in the ordinary course of business. If an individual, not in the real estate business, sells a particular piece of land, the gain would not be taxable as income because it constitutes only an occasional or unique transaction. In England such an irregular gain would be considered accretion to capital, not income. In the United States, however, as in many other places where the broader concept of income has come to be recognized, gains derived from sales, whether occasional or not, are held to be taxable income. To this procedure there is no objection from the modern economic point of view.

Thus the newer conception of income comprises not alone money, but money's worth; not alone regular, but irregular receipts; not

alone gains from a usufruct, but gains from the disposal of the thing that yields the usufruct. It is simply a survival of old errors, fortified no doubt by the desire to avoid practical administrative difficulties, that in England the gain from the sale of an isolated piece of property is held to be accretion to capital and that in both England and the United States the rental value of a house is held not to be income and that the reception of an inheritance is regarded as a capital increment.

In one point, however, almost all modern income tax laws are agreed. While there is still, as we have seen, a difference of attitude in the treatment of gains derived from sales, there is but little difference in the treatment of other gains. The distinction here is the one adverted to above between realized and unrealized gains. As we have seen, unrealized gains are inchoate gains, and inchoate gains are not income.

If I own a plot of land and secure no tenant for it, I receive no income and am nowhere subject to income tax. In some countries land is indeed taxable on its rental value; but rental value is not income. Since there is no gain at all, it is not subject to income tax. If, however, in the same year the value of the land rose, the owner would undoubtedly feel that he was wealthier. But would this appreciation in the value of the land constitute income? The answer everywhere is in the negative; and properly so, because we are in the presence of an unrealized gain. The land may have appreciated in value by the tax date; but it may equally well depreciate immediately thereafter. If the appreciation is realized through the sale of the property, there is of course a realized gain which is correctly held to be taxable income in the United States (although not in England). Again, if I sell the land and invest the proceeds in something else which then falls in value during the same taxable year, I am permitted to set off my loss against my profit. In that case there is no net gain and therefore no taxable income. The reason why a mere unrealized increase in the value of the land does not constitute income is primarily because of the uncertainty as to whether this particular consequence may not happen. In the same way, if I own securities which rise in value, there is a realized gain or taxable income only when the securities are sold.

We may put the conclusions briefly as follows:

Capital increment is a gain only when realized.

A realized capital increment is income in the wider sense.

An unrealized capital increment is not income, but a mere appreciation of capital.

As indicated above, the real point is the separation of the increment from the capital. This separation is necessary in order to constitute income. The increment when separated is income; the increment unseparated remains capital. Separation and realization are of the essence of the transmutation of capital into income. The capital as such remains intact: the increment or capital gain when actually realized and separated constitutes income.

6. *The Economic Nature of Stock Dividends*

We are now prepared for an analysis of the economic nature of stock dividends. This can be best introduced by taking an assumed case of a corporation with a capital of $100,000 divided into 1,000 shares, each worth par and owned by ten stockholders, each of whom owns ten shares of stock worth $10,000.

During the taxable year the corporation has net earnings of $50,000, on which it is of course subject to income tax. On the last day of the year, December 31, the stockholders hold a meeting in order to decide what to do with the $50,000. Three courses are open to them:

A) They may declare a cash dividend.
B) They may turn the earnings into surplus.
C) They may declare a stock dividend.

What happens in each of these cases?

A) After a cash dividend of $50 is declared on each share, the capital remains at $100,000, the number of shares is still 1,000, and the stock is still worth par, other things being the same, while the $50,000 is distributed to the stockholders in dividends, each of the stockholders receiving $5,000 as his dividend or income.

B) When the earnings are turned into surplus, the capital is now $150,000, the shares are still 1,000 in number, but each share is now worth $150. Each of the ten stockholders who continues to own ten shares now has property worth $15,000.

C) If a stock dividend of $50 is declared in additional shares to each owner of $100 worth of shares, the capital is now $150,000; the number of shares is now 1500 instead of 1,000, and the value of each share is still $100. Each of the ten stockholders now possess fifteen shares, instead of ten, and his investment is worth $15,000.

There are now two possibilities. Either (a) the earnings have been gradually accumulated during the year, with periodical statements open to the public, or (b) the knowledge of the increased earnings is kept secret from everyone until December 31, when action is taken.

What now will be the relative economic situation in these three cases?

A, a) The case of a cash dividend where the earnings have been known to accumulate during the year. Here the stock will gradually rise until, with the expectation of a $50 dividend, it will be worth on December 31, $150. Immediately after the declaration of the cash dividend, the stock will again fall to par. In actual life, indeed, there may be an interference with this normal result. As a matter of fact, each share may be worth a little less or a little more than $150, depending upon the market estimate of future prospects. Additions to surplus are often not expected to earn quite as much as the original investment, in which case the price will be less than $150; on the other hand, if continued large earnings are anticipated, the price may be above $150. Apart from these countervailing influences of the market, however, the situation as reflected in the statement of the beginning of this paragraph may be accepted as the normal one. In the same way the declaration of an extra cash dividend may lead to an expectation of continued earnings on the same scale, so that the price of the stock will not finally fall quite to par. But for purposes of simplicity this hypothesis may be eliminated, and the situation as described above may be considered the typical one.

A, b) If the earnings are unknown and unsuspected, the stock will naturally remain at par and the declaration of the cash dividend will not change the value of the stock (except in the same eventuality as before).

B, a) The case of addition to surplus, where the earnings have been accumulated throughout the year and have been well known to everybody. The stock will accordingly rise gradually until on December 31 it will reach $150. After the addition to the surplus the stock will remain at that figure.

B, b) If, on the other hand, the earnings have been unknown and unsuspected, the stock will remain at par until December 31, when it will jump to $150 and remain there, with the same practical qualifications as above.

C, a) In the case of the stock dividend, where the earnings have

been accumulated during the year and their existence known to all, the stock will as before rise to $150 by December 30. After the declaration of the stock dividend, the stock will on December 31 fall to par, just as in the case of the cash dividend.

C, b) If, before the declaration of the stock dividend, the earnings have been unknown and unsuspected, the value of each share will, precisely as in the case of the cash dividend, remain at par.

What now is the economic consequence of all this?

In A, the cash dividend, we are undoubtedly in the presence of actual income accruing to the stockholder. The cash paid to the stockholder is separated from the assets of the corporation; the gain, accruing to the stockholder, is actually realized by him. Both realization and separation are present.

In B, the addition to surplus, there is an appreciation of capital either (a) before or (b) after December 31. But this manifestly does not constitute any income to the shareholder. For, in the first place, there is no separation of the gain. It is merged into, and coalesces with, the surplus. And, secondly, there is no realized gain to the shareholder. His investment is worth more; but it has not been realized. It is like the appreciation in value of a house or a piece of land. There is no income because there is neither realization nor separation. It would be mere folly for a country to attempt to tax the shareholder because of an increase in the surplus of the corporation. The increase is indeed income to the corporation or rather it represents the disposition of the corporate income; but it is not income to the stockholder.[6]

[6] The one striking example of this error is the case of the Civil War tax of 1864, which provided (in Sec. 117) that "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits or income of any person entitled to the same, whether divided or otherwise." Under this section the Supreme Court held in *Collector* vs. *Hubbard* (12 Wall. 17) that the wording of the act justified the taxation to the individual of his share in the undivided corporate profits.

In extenuation of this law, however, the following facts must be borne in mind. The act of 1864 did not differentiate, as do our modern laws, between a corporate income tax and an individual income tax. The act of 1864 taxed only a few classes of corporations, like certain financial and transportation companies. (For a list see Seligman, *The Income Tax,* p. 444.) In no other case was there a corporate income tax. The provision, declaring the profits of all corporations (except those specifically mentioned), to be a part of the income of the stockholder, was only a crude attempt to reach the corporate income and to prevent the evasion of the tax. Since that time, however,

In C, the stock dividend, we again have an appreciation of capital; but each share either (a) falls in value before December 31 or (b) remains at the old figure after that date. Since each shareholder, however, now owns more shares than he did, the net result is precisely as in the case of B, the increase of surplus. There is no separation of anything. There are indeed more paper certificates; but this does not change the essential nature of the transaction. There is no more separation of the assets than in B, the addition to surplus. There is no separation of the assets as in A, the cash dividend. The assets remain an undivided whole, whether they nominally consist of surplus or of any other item. Nor is there any realization. The gain or capital increment is unrealized gain or inchoate income, precisely as in the case of B, the addition to surplus. There is no income to the shareholder, therefore, because there is neither realization nor separation.

It might be objected that in C, the stock dividend, the owner of 100 shares which previously were worth $10,000 may take his 50 new shares and sell them for $5,000, leaving his original capital of $10,000 unimpaired. This, as it might be said, puts C, the stock dividend, on a plane with A, the cash dividend. For the owner in the latter case will obviously sell his dividends for $5,000, leaving his original capital of $10,000 unimpaired.

progress has been made in the theory of the income tax and of the corporate or business tax. We now have in every country, including our own, a corporate income tax side by side with the individual income tax. There is therefore no justification for a continuance of the clumsy method of the Civil War tax. No country today thinks of characterizing as income the undivided share of the stockholder in the surplus of a corporation. The Hubbard case, therefore, has no application to present conditions, and from the economic point of view it was irrelevant for the government to cite it (Eisner *vs.* Macumber, *Brief for the United States,* p. 11).

The law of 1864 endeavored to tax the corporate income to the individual shareholder, because no attempt was made to tax it to the corporation. But under the present law the corporate income *is* taxed to the corporation, and there is accordingly no justification for taxing it to the individual. For a tax on undivided profits would then tax the same income twice. This, of course, does not mean that our present practice of levying, in addition to the corporate income tax, a separate tax on the stockholder when he actually realizes his own income is theoretically or practically indefensible. For in this case there are two separate incomes, one to the corporation and one to the individual. Whereas in the contemplation of the act of 1864 there was only one income—that of the corporation, taxable to the individual solely because it seemed inexpedient to tax it to the corporation.

It is a mistake, however, to think that this creates an analogy between C and A, that is, between the stock dividend and the cash dividend. For, in the case of B, the addition to surplus, the stockholder could have done precisely the same thing. That is, he could have taken 33 1/3 shares, sold them at $150, netted $5,000, and still have remaining his 66 2/3 shares worth, at $150, the sum of $10,000.

In this respect, then, there is no difference between A, B and C. If the stockholder cashes in his gains, all three cases are on a par. In none of these cases would there be any difference between income from capital and accretion to capital. For, when the gains are cashed in, the accretion to the capital is separated from the capital, leaving the capital unimpaired. Furthermore, if the stockholder sells all his stock, he will get in every case $15,000, and there will be in every case a gain or taxable income of $5,000. A capital gain cannot be realized without being separated; and when we have both separation and realization, capital increment has all the earmarks of income. If the stockholder sells his stock dividend the proceeds are undoubtedly income.

The question at issue, however, is entirely different: namely, what is the situation if the stockholder does *not* sell the stock? Here the real difference is between A, the cash dividend, on the one hand, and both B and C, the increase of surplus and the stock dividend, on the other.

In A, the cash dividend, the realized gain is income; in B, the increase in surplus, the unrealized gain is not income; in C, the stock dividend, the unrealized gain is not income.

Or, to put it in other words; A, the cash dividend, is indisputably income; B, the addition to surplus, is simply accretion to capital; C, the stock dividend, is equally nothing but accretion to capital. C then is like B and not like A; and in neither B nor C is the capital accretion income, because in neither case is the gain separated or realized. The stock dividend is like an increased surplus; it is not like a cash dividend. In fact, a stock dividend is not a dividend at all, in the sense in which a cash dividend is a dividend. The entire confusion really arises from a misnomer. For a dividend implies an actually realized increase of wealth; whereas, in a stock dividend there is no actually realized increase of wealth. As a matter of fact: in C, a (the stock dividend where the earnings have been slowly and openly accumulated) the stockholder is certainly no richer after December 31 than he was on

December 30. And while in C, b (the stock dividend where the earnings have been unknown and unsuspected) the stockholder is in a certain sense richer on December 31 than on December 30, the gain is an unrealized increase of wealth, a mere paper increment. What is most important, above all, is that he is no richer than he would have been if there had been no stock dividend at all but a simple distribution to surplus. The income tax, it must be remembered, is not a tax on every increase of wealth actual or imaginary; it is a tax only on income; and capital increment constitutes income, as we have seen, only when invested with the attributes of separation and realization.

A final objection might be raised as to the result of a fourth possibility in addition to the three alternatives mentioned on page 530. The directors of the corporation might decide to invest the $50,000 earnings in the securities of another corporation and then declare a dividend in kind. This is often done nowadays. But, if a distribution in "other stock" is income, it is triumphantly asked, why is a distribution of its own stock not likewise income? This objection has confused many thinkers. Yet the answer to the question is very simple. For in the one case there are both separation and realization; in the other, there is neither separation nor realization.

In the one case, the directors actually take the $50,000 and separate them from the assets. Whether they turn over to the stockholders the $50,000 in cash or buy commodities like copper and wool, or securities like stocks and bonds, and then turn them over to the stockholders is immaterial. In every case there is a separation of earnings from the assets and in every case the earnings when separated from the assets and turned over to the stockholder constitute his income. Whether the stockholder gets cash, or commodities in the shape of copper or wool, or the securities of the other corporation is immaterial to him. In every case he gets something which is the result of a separation from the principal. But if he gets a stock dividend, *i.e.*, the securities of his own corporation, he does not get anything which has been separated from the principal. He gets only an additional evidence of his share in the undivided and unseparated assets. In the one case there is separation; in the other there is no separation.

Nor can we say that the acquisition of a share of stock in another corporation is unrealized gain. On the contrary, it is realized in the true economic sense of the term. If, instead of a cash dividend, the stockholder receives some copper or wool, we

should not say that it is unrealized gain, and that too, whether he keeps or sells the copper or wool. If, however, he receives instead of the copper or wool a share of stock in some other corporation, we should again not say the gain was unrealized and, that too, whether he keeps or sells the stock. For in every case where the acquisition is the result of a distinct separation of assets—a separation of earnings from the principal—there is realization; and where there is realization there is income. It is beside the point to claim that this share in a new corporation might fall in value before he sold it: The copper or wool might equally depreciate before he disposed of it; and the bank in which he deposited the cash dividend or the individual to whom he loaned the cash might equally well fail, so that he would possibly receive during the taxable year only a part of the original sum. The cash dividend is indisputably income even if the proceeds are subsequently lost. Whatever be the policy of the law toward deduction for losses, and irrespective of whether the taxpayer is permitted to count as a loss the mere depreciation of the copper or wool or "other stock," there can be no doubt that the gain (from which a deduction may or may not be permitted) is realized as soon as there is an acquisition of cash, of copper or wool, or of "other stock." Realization does not mean immunity from loss. Realization occurs as soon as actual separation has been effected.

Thus in all these cases—cash dividend, copper or wool, and "other stock" there are both separation and realization: in a stock dividend there is neither separation nor realization. The gain from "other stock" is income; the gain from a stock dividend is not income.

The real distinction to be kept continually in mind in threading one's way through the mazes of the income tax is between the actual receipt of income on the one hand and the unrealized appreciation of capital on the other. A cash dividend is an example of the former; a stock dividend is an example of the latter. In the cash dividend, as in the "other stock," the gain is realized and separated; in the stock dividend, as in the addition to surplus, the gain is unrealized and unseparated. The first is income; the second is capital. A cash dividend is income; a stock dividend is not income.

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